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Energy, Trade & Commodities Alert

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The Indirect (and likely unintended) Consequences of the Deep-Sea Horizon Drilling Ban

Reports that the United States Government is set to issue a new ban on deep sea drilling in U.S. waters[1] in response to the Deepwater Horizon oil spill, could cause a further spate of force majeure claims under drilling contracts in the Gulf of Mexico. Press reports indicated that at least one drilling contract has already come before the Louisiana courts in connection with such claims. Other consequences of the drilling ban could include wasted operating costs, wasted rent during a non-productive period of the lease, loss of future production, and even the reclassification of reserves if production from fields becomes less likely.

What is the upshot for companies affected by the drilling ban or similar government action elsewhere?

Force Majeure provisions in drilling contracts

The purpose of force majeure clauses is to legislate the consequences of a party's failure to perform contractual obligations as a result of circumstances over which it has no control. FM Clauses, as they are known, typically permit parties faced with such an event to suspend performance for a reasonable period of time, and ultimately to end the contract altogether if the disruptive event continues for a lengthy duration.

What constitutes a force majeure event normally depends on the definition adopted by the parties. While government decrees, such as the US drilling ban, as well other changes in laws prohibiting certain activities, are often included in contractual definitions of force majeure events, this will depend on the language employed in a given contract. In the case of offshore drilling contracts, many (such as those based on IADC models) expressly recognise government legislation or decree as potential force majeure events. To successfully invoke a force majeure clause the party relying on it must be able to show that its inability to perform is caused by the force majeure event.

Where a force majeure clause is successfully invoked, the contract normally spells out the consequences for the parties. These will vary from contract to contract, but many drilling contracts legislate for the suspension of performance for an interim period; the payment of a "force majeure daily rate"; and the eventual termination of the entire contract if the force majeure event continues for a lengthy or uncertain duration.

What if there is no force majeure clause?

Even where a contract contains no force majeure clause, changes in law that render its performance impermissible or illegal, will likely excuse performance. Such changes could even bring about the termination or discharge of the contract in its entirety, under the legal doctrines of "frustration", "illegality" or "impossibility". Whether a temporary measure, such as the US drilling ban, can bring about the end of a drilling contract will depend on a variety of such factors as the length of the contract compared with the length of the measure.

If a contract is discharged in this manner, existing liabilities will normally remain due (for example payment due for past performance), but all future obligations no longer bind the parties.

What will happen when the ban is lifted?

In theory, when the drilling ban is lifted, performance of drilling and related contracts could simply resume. However, it is possible that the end of the moratorium will conclude with the introduction of a new safety regime. If a new regime is introduced that renders performance radically different from that which was contracted for, or significantly alters the economic burden of performance, parties to contracts containing hardship clauses could be required to attempt to renegotiate the contract, failing which the contract could be brought to an end.

The doctrines of frustration or impossibility could also operate in these circumstances to excuse performance or even completely discharge future contractual obligations.

Non-contractual recourse?

Companies dealing with the consequences of the drilling ban, or similar government action in other areas might therefore find that much of the resulting losses or wasted expenditures are not recoverable under the relevant drilling or other contracts.

Recourse against the government introducing the measure (the U.S. Government in the case of the drilling ban) may be available through the domestic courts, although if the ultimate decree is deemed lawful, any compensation available might be restricted.

Foreign companies controlled by foreign investors might also be able to bring international arbitration claims against the relevant government pursuant to international investment treaties between the 'host' and the relevant 'home' states. Companies would likely have to show that they were treated unfairly and inequitably, or that their contractual rights were expropriated as a result of the decree or measure in question.

Whether such arguments are available, or indeed whether the government actions could be justified, for example because the measure necessary to safeguard the essential interests of the state from immediate peril, as recognised under international law, would depend on the terms of the treaty in question and surrounding factual circumstances.

Companies might also consider the applicability of any political risk or other business interruption insurance policies they have taken.

Conclusion

The oil and gas industry is accustomed to dealing with political risk. Having to deal with the consequences of unexpected Government intervention in U.S. waters might nevertheless have come as a surprise.

Parties facing losses as a result of the U.S. drilling ban should carefully consider the position under relevant contracts, but might also look to their insurers or indeed to the US government for any non-recouped losses.

It is to be hoped that as the leak is successfully plugged by BP, so can legal and commercial uncertainties be reduced in the months to come.

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1. The first moratorium was ruled unlawful by a US Federal Court: http://www.bbc.co.uk/news/10377836.

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